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IN THE
Supreme Court of the United States
OCTOBER TERM, 1996

UNITED STATES OF AMERICA,
Petitioner,
v.
JAMES HERMAN O'HAGAN,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE* SUGGESTING REVERSAL IN PART

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QUESTION PRESENTED

Irrespective of whether "misappropriation" is a fraud or deceit actionable under Section 10(b), when a defendant misappropriates inside information in order to trade securities, does the defendant thereby "use or employ" the misappropriation "in connection with the purchase or sale of any security?"

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
TABLE OF AUTHORITIES	iv
PRELIMINARY STATEMENT	1
INTEREST OF THE INSTITUTE AS *AMICUS CURIAE*	1
ARGUMENT	2
I. THIS COURT'S CONSTRUCTION OF THE "USE OR EMPLOY . . . IN CONNECTION WITH" REQUIREMENT OF SECTION 10(b) WILL HAVE FAR-REACHING IMPLICATIONS IN THE POST-*CENTRAL BANK* ERA	2
II. THE "USE OF EMPLOY . . . IN CONNECTION WITH" REQUIREMENT IS A SEPARATE ELEMENT OF LIABILITY FROM FRAUD OR DECEIT; BOTH MUST BE SATISFIED TO STATE A SECTION 10(b) CLAIM	4
CONCLUSION	8

TABLE OF AUTHORITIES

CASES	Page
Anixter v. Home-Stake Prod. Co., 77 F.3d 1215 (10th Cir. 1996)	3
Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)	3
Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 114 S. Ct. 1439 (1994)	2, 5
Frymire-Brinati v. KPMG Peat Marwick, 2 F.3d 183 (7th Cir. 1993)	7
SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991), *cert. denied*, 502 U.S. 1071 (1992)	5
SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985)	5
Superintendent of Ins. v. Bankers Life & Cas., 404 U.S. 6 (1971)	3
STATUTE	
15 U.S.C. § 78j (1994)	*passim*
15 U.S.C. § 78r (1994)	*passim*

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PRELIMINARY STATEMENT

The American Institute of Certified Public Accountants (the "Institute") submits this brief as *amicus curiae*, pursuant to Rule 37.3 of the Rules of this Court, suggesting reversal in part.[1]

INTEREST OF THE INSTITUTE AS *AMICUS CURIAE*

The Institute is the national organization of the certified public accounting profession, with more than 325,000 members. The Institute is interested in the Section 10(b)

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[1] The Institute's brief is submitted on written consents of the parties, which were filed with the Clerk of the Court.

question presented in this case; in particular, the proper interpretation of the "use or employ . . . in connection with" requirement as an element of Section 10(b) liability. The Court's ruling on this issue will extend beyond the misappropriation context and will affect how the lower courts apply the statutory language in other cases, including ones involving more typical allegations of misrepresentations and omissions.

Another case pending before the Court, *Ernst & Young v. McGann*, No. 96-1075, posits the same "use or employ . . . in connection with" question in the context of an alleged misrepresentation by an independent auditor. The Institute believes that consideration of the different factual circumstances of the *O'Hagan* and *McGann* cases will assist the Court in developing a coherent interpretation of the statutory language that can be applied by the lower courts in all Section 10(b) cases.[2]

ARGUMENT

I. THIS COURT'S CONSTRUCTION OF THE "USE OR EMPLOY . . . IN CONNECTION WITH" REQUIREMENT OF SECTION 10(b) WILL HAVE FAR-REACHING IMPLICATIONS IN THE POST-*CENTRAL BANK* ERA.

This Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439 (1994), which overturned aiding and abetting liability under Section 10(b), has focused greater attention on the proper construction of the "use or employ . . . in connection with" requirement of the statute. While aiding and abetting liability existed, there was little need for courts to draw careful distinctions between "primary" and "secondary" liability under the statute. Post-*Central Bank*,

[2] The Institute will file an *amicus* brief supporting Ernst & Young's petition in *McGann* on March 4, 1997. The Institute will serve the *O'Hagan* parties with copies of its *McGann* brief.

the statutory words "*use or employ . . . in connection with the purchase or sale of any security*" have heightened importance in determining conduct that violates the statute and conduct that does not. *See Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1230 (10th Cir. 1996) ("It is obvious from our discussion analyzing accountant behavior under § 10(b) that distinctions in conduct between primary and secondary liability are elusive. Prior to *Central Bank* the distinction was academic. Now it is pivotal.").

The decision below involves application of the "use or employ . . . in connection with" requirement to a defendant's conduct in a misappropriation case. It is equally important for the lower courts to interpret and apply the requirement correctly as to defendants' conduct in other Section 10(b) contexts, including the more typical cases of alleged misrepresentations or omissions.[3] The Institute respectfully urges the Court, in addressing the meaning of these statutory words here, to consider the far-reaching effects that its ruling will have on the full range of Section 10(b) litigation. A proper construction of the requirement should allow for coherent application in varying factual contexts, preserve a meaningful distinction between "primary" and "secondary" liability under the statute, and harmonize the implied Section 10(b) action with the express causes of action in the federal securities laws (most notably, Section 18).

[3] The Court has not previously interpreted the "use or employ . . . in connection with" requirement to determine the sufficiency of a *defendant's* own "connection" to any purchase or sale of securities. In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 727 (1975), the Court looked only at the "connection" required to be a Section 10(b) plaintiff. In *Superintendent of Insurance v. Bankers Life & Casualty*, 404 U.S. 6, 12 (1971), the Court analyzed a complex financial fraud to determine whether it was "in connection with" underlying securities transactions in which both the plaintiffs and defendants were participants.

II. THE "USE OR EMPLOY . . . IN CONNECTION WITH" REQUIREMENT IS A SEPARATE ELEMENT OF LIABILITY FROM FRAUD OR DECEIT; BOTH MUST BE SATISFIED TO STATE A SECTION 10(b) CLAIM.

The Eighth Circuit's decision reflects a troubling inability by the lower courts to give effect to the plain meaning of the "use or employ . . . in connection with" requirement of Section 10(b). Mr. O'Hagan *traded stock* on the basis of misappropriated inside information. *Pet. App.* at 2a-3a. Mr. O'Hagan surely "used" the misappropriated information "in connection with" the purchase of a security, irrespective of whether misappropriation constitutes a "deceptive device" within the meaning of the statute.

The Eighth Circuit held that Mr. O'Hagan was not liable under Section 10(b) for two independent reasons. *First*, the court held that the misappropriation at issue did not constitute an actionable fraud or deceit under Section 10(b). *Id.* at 12a-13a. The Institute takes no position on this part of the decision.

Second, the court held that Mr. O'Hagan had not acted "in connection with" the purchase or sale of a security, even though he *traded stock*. *Id.* at 13a. The court reached this incongruous result by construing the statutory words "in connection with" to define the various classes of persons Congress intended to protect under Section 10(b); *i.e.*, purchasers, sellers, and other "market participants." *Id.* at 13a-14a. The court then concluded that, because Mr. O'Hagan had not breached any fiduciary duty to any of these persons, he had not acted "in connection with" a stock trade for Section 10(b) purposes. *Id.* The full statutory text, however, plainly requires that a *defendant* "use or employ" an alleged fraud "in connection with" a securities transaction.[4] The Eighth Circuit's

[4] Although the words "use or employ" are the operative verbs of the statute, the Eighth Circuit nowhere mentions them in its opinion.

analysis wrongly focused on the effect of the misappropriation on investors, rather than on the defendant's actual *use* of the inside information *in connection with* his stock trades.[5]

The "use or employ . . . in connection with" requirement necessarily operates as a *limitation* on Section 10(b) liability. To give it proper effect, the requirement must be viewed as a separate element from fraud. Whatever a defendant's alleged wrong may be, he or she must "use or employ" it "in connection with" a securities transaction for liability to arise. Both the fraud and the "use or employ . . . in connection with" elements must be shown independently to state a Section 10(b) claim. *Cf. Central Bank*, 114 S. Ct. at 1455 ("[a]ll of the [statutory] requirements for primary liability" must be met.) (emphasis in original).

As a logical matter, truthful statements "used or employed . . . in connection with" a securities transaction may satisfy this element of the statute. Conversely, false representations may constitute fraud within the meaning of Section 10(b), but if the defendant does not "use or employ" them "in connection with" a securities transaction, this separate statutory element is lacking.

The *McGann* case further illustrates this point. In *McGann*, an independent auditor submitted an audit report to a client, which the client later used in a required Form 10-K filing with the SEC. *See McGann Pet. App.* at 3a. The auditor had no involvement or interest in

[5] Courts in other misappropriation cases have found the "use or employ . . . in connection with" requirement to be readily satisfied where a defendant *uses* misappropriated inside information to trade stocks. *See, e.g., SEC v. Cherif*, 933 F.2d 403, 410 (7th Cir. 1991) (requirement satisfied by defendant's use of inside information to purchase or sell securities), *cert. denied*, 502 U.S. 1071 (1992); *SEC v. Materia*, 745 F.2d 197, 203 (2d Cir. 1984) (use of inside information to purchase stock provides "self-evident nexus"), *cert. denied*, 471 U.S. 1053 (1985).

the disputed stock transactions. The Ninth Circuit nonetheless held that the auditor had "use[d] or employ[ed]" the report "in connection with the purchase or sale" of a security. *Id.* at 16a-17a. The Ninth Circuit reached this conclusion by making the same mistake as the Eighth Circuit: the court ignored the statutory text, and looked instead to perceived investor protection policies underlying Section 10(b). The court concluded that the "use or employ . . . in connection with" requirement is satisfied whenever any person makes any statement "in a manner reasonably calculated to influence the investing public." *Id.* at 15a. The court's focus was improperly on the *making* of a false statement and its potential *effect* on investors.

Section 10(b), however, plainly requires more than the making of a false statement that affects the price of a stock. The statutory words say that the defendant must further "*use*" the statement "*in connection with*" a purchase or sale of securities. This requirement distinguishes the implied Section 10(b) action from the express right of action under Section 18. Section 18 imposes civil liability on accountants and others who "make or cause to be made" a false statement in a publicly filed document that "affect[s]" the price of a stock and that is relied upon by investors.[6] Section 18 demonstrates that Congress knew which words to choose to create an express remedy

[6] Section 18 states, in pertinent part, that:

> Any person who shall make or cause to be made any statement in any . . . document filed pursuant to this chapter or any rule or regulation thereunder . . . which statement was . . . false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement . . . unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.

15 U.S.C. § 78r (1994).

for the making of false statements that affect stock prices (*viz*, precisely the conduct alleged against the *McGann* auditor). The very different words chosen by Congress in Section 10(b) must be read to mean something more. The policy-based *McGann* holding fails to give proper effect to the plain meaning of the "use or employ . . . in connection with" words of Section 10(b) and, in so doing, improperly nullifies the actual reliance requirement of Section 18 by permitting plaintiffs—in *every* case involving an allegedly false SEC filing—to plead the same alleged false statements as "fraud-on-the-market" claims under Section 10(b).[7]

The *McGann* holding thus poses the same problem as the one in *O'Hagan*, but from the opposite end of Section 10(b): the independent auditor's alleged misrepresentation may constitute a "deceptive device" within the meaning of the statute, but the auditor did not "use or employ" the misrepresentation "in connection with" any of the disputed transactions. To the contrary, in cases like *McGann*, the independent auditor is retained by the client, audits financial statements prepared by the client, and submits the audit report to the client. The client may use the report for a host of different business purposes, including compliance with regulatory disclosure requirements. *See Frymire-Brinati v. KPMG Peat Marwick*, 2 F.3d 183, 190 (7th Cir. 1993) (discussing different client uses of audit reports). Whatever uses the client may make of its audited financial statements, the auditor's role is necessarily secondary.[8] It strains the text of Section 10(b) too far to say—especially after *Central Bank*—that, by merely issuing the audit report to the client, the independent auditor has "used or employed" the report "in connection with the purchase or sale of any security."

[7] *See AICPA McGann Amicus Brief* at I.B.

[8] *See McGann Pet.* at 21-23; *AICPA McGann Amicus Brief* at II.A.

This separate requirement for primary Section 10(b) liability simply is not satisfied.

In sum, giving proper effect to the plain text of the statute allows for coherent application of the "use or employ . . . in connection with" requirement as a separate element of Section 10(b) liability in varying fact scenarios. It also preserves a meaningful distinction between "primary" and "secondary" liability under the statute, and harmonizes the implied Section 10(b) and express Section 18 actions.

CONCLUSION

For the foregoing reasons, the Institute respectfully urges the Court to hold (1) that Section 10(b) requires, for primary liability under the statute, that a defendant "use or employ" a fraud "in connection with" a particular purchase or sale of securities, and (2) that this element must be satisfied *independently* of whether the fraud itself is a "deceptive device" within the meaning of the statute.

Respectfully submitted,

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